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CORPORATE GOVERNANCE IN JAPAN

SUMMARY

Managers of publicly owned corporations are expected to maximize company profits, a process that assures the firm's shareholders the highest possible return both over the short run and the long term. Until recently Japanese corporate management did not feel it had to worry about the near-term financial interests of stockholders as long as the company produced a reasonable long-term return. This freedom partially reflects the fact that a majority of shareholders in many Japanese corporations consist of friendly institutional investors and, until recently, they rarely challenged the decisions of company executives. Moreover, the rapid growth of sales and profits through the 1980s plus the perceived low cost of capital in Japan made a longer time horizon economically rational. Buffered from the narrow concerns of stockholders, Japanese corporate officials had considerable decisionmaking flexibility.

The steep slide in Japanese stock prices since the end of 1989 has prompted institutional investors in Japan to review their management-knows-best attitudes. With their once huge paper capital gains disappearing, banks, insurers and other institutional investors have begun to urge companies in which they own stock to hike dividend payouts; otherwise, they have warned, they might consider selling their shares. A series of financial and securities market scandals over the past five years or so also has forced institutional investors to reassess their hands-off position on corporate management.

Recent efforts to strengthen corporate governance in Japan include both legislative and institutional reforms. At the most basic level firms are examining the role of outside directors and the need for an independent audit committee. These and other measures are expected to help make Japanese corporate behavior more transparent and easier for corporate monitors and companies' overseas counterparts to understand.

Corporate Management and Shareholders

The different investment horizons of corporate managers in the United States and Japan show up on every list of the competitive strengths and weaknesses of American and Japanese companies. Business executives in this country are said to be fixated with short-term profits and the boost that strong quarterly earnings give to their company's stock price — a preoccupation that is traced in part to the quick-return investment objectives of U.S. shareholders. Management in Japan, it is argued in contrast, has the latitude to focus on the company's long-term financial performance because most of the firm's stock is held by stable, friendly institutional investors concerned more about share-price appreciation over time than immediate gains.

While the short-run, bottom-line orientation of American management is a staple of the accepted thinking about what companies in this country are doing wrong, virtually no systematic evidence has been produced to confirm that businessmen here opt for investments with less risk or shorter payback periods than market rates of return warrant. The conventional wisdom is on firmer ground, however, in linking the long-term perspective of Japanese corporate managers to the ownership of large blocks of stock by supportive institutional investors.

Banks, insurance companies, manufacturers and other institutional investors control far more of the shares of publicly owned companies in Japan than in the United States (see Tables 1 and 2). Even if the stock held by brokerage houses and investment trusts is subtracted from the institutional total on the assumption that these investors often buy and sell stock for short-term gains, roughly two-thirds of all shares in Japan still are held by businesses that have invested for the long haul.

Table 1: **Composition of Corporate Equity Ownership in Japan, FY 1955 and FY 1990**

(percentage of unit shares* of all publicly owned companies)

	FY 1955	FY 1990
Japanese Individuals	53.1%	23.1%
Japanese Institutions	45.1	72.1
Central and Local Governments	0.4	0.6
Nonfinancial Corporations	13.2	25.2
Financial Institutions	23.6	45.2
Banks and Trust Banks	n.a.	26.1
Of which: Investment Trusts	4.1	3.6
Life Insurance Companies	n.a.	13.2
Nonlife Insurance Companies	n.a.	4.1
Other Financial Institutions	n.a.	1.8
Brokerage Houses	7.9	1.7
Foreigners**	1.8	4.2

*A unit share is calculated as 1,000 shares of a ¥50 stock or 100 shares of a ¥500 stock. In FY 1990 there were 394.9 million unit shares. The FY 1990 data exclude stockholders who own less than one unit share.
**Includes both individual and institutional investors.

Source: Zenkoku Shoken Torihikijo Kyogikai, *Kabushiki Bunpu Jokyo Chosa.*

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Table 2: **Composition of Corporate Equity Ownership in the United States, 1955 and 1990**

(percentage of market value of all U.S. equities)

	1955	1990
Individuals	77.0%	46.7%
Institutions	23.0	53.3
Private Pension Funds	1.3	19.9
Bank Trusts*	n.a.	9.2
State and Local Retirement Funds	0.6	8.3
Mutual Funds	3.9	7.2
Insurance Companies	2.3	6.9
Foundations and Endowments	n.a.	1.8

*Commercial banks are not allowed to own stocks in the United States.

Source: Columbia Institutional Investor Project, cited in testimony of Richard Breeden, chairman, Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, October 17, 1991, p. 11.

Among the long-term institutional investors in any one of the nearly 2,100 companies listed on the Tokyo, Osaka or other Japanese stock exchanges are other members of the same corporate grouping or *keiretsu*, the firm's customers, its major bank as well as other banks that provide financing, plus the insurers that handle the company's pension fund or corporate insurance. Having acquired stock in the company primarily to cement a long-term business relationship, these investors are willing to give management considerable free rein on business strategy, including the decision to retain a high proportion of after-tax income, as long as they are confident that their investment will pay off over the long run through share-price appreciation.

Reflecting the tendency of many Japanese institutional investors to hold stock on a long-term basis, the average level of cross-stockholding among *keiretsu* members has been stable since the late 1970s (see *JEI Report* No. 2A, January 12, 1990). For example, between 1975 and 1988 mutual shareholding among firms belonging to the Mitsui Group dipped only from 17.5 percent of all shares outstanding to 17.1 percent. The change was similarly limited for companies in the Mitsubishi Group (27.8 percent to 26.9 percent). The same was true of cross-stockholding within the Sumitomo Group (24.4 percent in 1988 versus 25.9 percent in 1975).

Unlike in the United States, banks in Japan are allowed to own up to 5 percent of the shares of a nonbank company; as much as 40 percent of a nonbank corporation's outstanding stock can be held by financial institutions as a group. Typically, any bank that lends to a firm owns some of that company's stock. The bank that coordinates lending to a business and oversees its financial status is expected to have the largest shareholding among banks. Therefore, a company's lead bank usually buys 4 to 5 percent of the firm's shares to demonstrate its key financial role.

While many institutional investors in Japan have bought stock in domestic companies primarily for business reasons, the run-up in Japanese stock prices over time and especially in the late 1980s added a financial rationale for keeping their money in the stock market rather than putting it elsewhere. Big institutional investors generally invested in a core group of companies before their stock was offered to the public, paying only book value for their shares. In buying stock in other public corporations they paid market prices, but these purchases often were made more than a decade ago. Regardless of the timing, the stock market boom of the late 1980s offered institutional investors potentially huge capital gains.

Impact of the Stock Market Sell-Off

Japanese stock prices have taken a beating since they reached a postwar high at the end of 1989. The Nikkei average of 225 stocks listed on the first section of the Tokyo Stock Exchange plummeted from 38,915.87 to a six-year low of 14,309.41 in mid-August, dragged down by the economy's slowing performance and an accompanying drop in corporate sales and profits as well as by a series of financial scandals and the deflation of the speculative boom of the late 1980s. This steep slide has hurt institutional investors across-the-board, but banks and insurance companies, the market's biggest investors, have been the hardest hit.

As the value of their stock portfolios has contracted, financial institutions have become increasingly concerned about the relatively low rates of return they earn on their investments in public corporations. Sukenari Ito, president of Nippon Life Insurance Co., reflected the thinking of other financial firms' executives when he recently argued that Japanese companies need to raise the rate on return of equity to the U.S. level of around 10 percent from the current figure of 6.9 percent.[1] Mr. Ito also said the proportion of after-tax income paid out by Japanese corporations as dividends should be raised from the present 30 percent or so to at least 40 percent, a change that still would leave the payout ratio well below the comparable American number (see *JEI Report* No. 15A, April 17, 1992). Some institutional investors even have hinted that they might sell their stockholdings unless corporate management responds positively to their calls for higher dividends. This threat is especially effective in an unstable stock market since it could cause further drops in share prices.

Recent stock market conditions also have caused *keiretsu* companies to question the value of mutual shareholding practices. *Keiretsu* companies are less active than financial firms in promoting higher dividends since their investments in group firms are motivated by long-term business relationships as well as the desire to keep the ownership of *keiretsu*-affiliated companies in friendly hands (see *JEI Report* No. 35A, September 20, 1991). But given the bleak prospects for financial returns, even these investors are beginning to reassess their stockholding rationales.

According to a May survey by *Nikkei Business* of the companies listed on the TSE's first section (excluding banks), 53 percent of the 220 firms that responded said they could expect no capital gains if the Nikkei were to drop below 15,000.[2] Asked when the company might consider selling stock in a member of its corporate grouping, only 1.7 percent of the respondents said they would at a time when the stock's market value was less than its book value. If holding the stock became too costly for any unspecified business reason, then 19.1 percent of those surveyed said they would sell. More than half (58 percent) said they would not maintain their cross-shareholdings if business relationships stopped being mutually beneficial. If a business partner sold the company's stock, then 42 percent of the companies responding might similarly sell the partner's stock.

This survey confirmed that pure economic reasons rarely underpin cross-stockholding in Japan. But the survey also indicated that in today's economic environment financial pressures might induce some companies to sell their shares in affiliated *keiretsu* firms. If these companies do act, affected group members most likely would retaliate by selling their corresponding shares, producing a possible domino effect. To reduce the likelihood of this outcome the Ministry of Finance announced in mid-August that public corporations would be allowed to defer reporting stock portfolio losses until the end of the fiscal year next March (see *JEI Report* No. 33B, August 28, 1992). This emergency move, Tokyo hoped, would reduce the pressure on banks and other financial institutions to sell stock to improve their upcoming half-year financial reports.

New Approach to Corporate Governance

A series of scandals has rocked Japanese financial markets over the last five years or so, including client compensation for stock trading losses by brokers, manipulation of stock prices and insider trading. In an effort to mend the damaged image of Japanese business Keidanren (Japan Federation of Economic Organizations) unveiled a set of guidelines for corporate ethics in September

1991. The guidelines stress the responsibility of corporate executives for upholding ethical standards and complying with laws and regulations, as well as the need for fairness in corporate behavior, especially with regard to shareholders, consumers and other community members. The document also calls for institutional reform, including strengthened in-house oversight of corporate management.[3] With these guidelines in mind, Japanese businesses have started to review their corporate governance, including the role of directors, auditors and shareholders.

Directors - As in the United States, company directors are elected at shareholders' meetings in Japan, but the similarities end almost there. Outside directors are well-represented on the boards of many U.S. corporations, particularly Fortune 500 companies. Their presence reflects in part the listing standards of the New York Stock Exchange and other major U.S. exchanges or the National Association of Securities Dealers for the NASDAQ (National Association of Securities Dealers Automated Quotation System) market. NASD, for example, requires that at least two directors be selected from outside the company.[4] If member firms do not meet this standard, their stock automatically is delisted from the NASDAQ market, a fairly strict means of enforcement. The NYSE has the same trading requirement. Dale M. Hanson, chief executive officer of the California Public Employees' Retirement System, the biggest U.S. institutional investor, has said, "Directors should have the ability to effectively direct, oversee and evaluate the company's management. ... CalPERS strongly encourages distinguished or independent directors."[5]

Independent directors are rarely found on the boards of public corporations in Japan, even in major companies that sometimes have more than 50 directors. Occasionally, a few outsiders serve as full- or part-time directors but, unlike the business executives, lawyers and academics who are elected to boards in the United States, they usually serve concurrently as directors of companies in the same *keiretsu* or on the boards of the firm's main bank. Moreover, their oversight role and decisionmaking influence are relatively limited — unless the company gets into financial trouble.

Since major nonbank firms in Japan rely on bank loans for a significant portion of their financing (see Table 3), Japanese bankers, particularly those affiliated with the company's lead bank,

Table 3: **Sources of Financing of Major Nonbank Firms in Japan and the United States, 1970-89**

(net flow basis; share)

	1970-74	1975-79	1980-84	1985-89
Japan				
Internal Sources	41.6%	50.6%	59.0%	52.3%
External Sources	58.4	49.4	41.0	47.7
Loans	50.0	41.5	35.0	32.1
Stocks and Bonds	5.7	7.5	6.2	11.0
Other*	2.7	0.4	-0.2	4.6
United States				
Internal Sources	55.1%	69.7%	74.2%	85.4%
External Sources	44.9	30.3	25.8	14.6
Loans	25.6	16.3	15.5	14.0
Stocks and Bonds	18.0	14.0	9.5	-1.3
Other*	1.3	0.0	0.8	1.9

*Including overseas financing.

Source: Bank of Japan

have a keen interest in monitoring the company's day-to-day financial status. In times of shaky financial conditions the main bank no longer acts as a silent business partner but exercises much more power.[6] If a company is on the verge of bankruptcy, its main bank in consultation with government officials proposes a restructuring plan, which sometimes includes a change of executives. (Since corporate governance in Japan reinforces the authority of company presidents or chairmen, who have most of the decisionmaking authority — including decisions on personnel matters, the removal of a chief executive by a board of directors gets considerable play in the Japanese media.) In general, though, banks' influence in corporate governance declined in the second half of the 1980s, as large Japanese firms further reduced their dependence on bank borrowing and raised more money by selling stock or issuing convertible and warrant bonds.

Auditors - More thorough auditing might have prevented some of the financial problems now confronting Japanese companies, including money-losing investments made in the late 1980s when the cost of capital was extremely low and profitability of little concern. By law auditors are selected at shareholders' meetings. In most companies in Japan, however, these jobs are considered honorary positions reserved for retired directors of the firm. NYSE and NASD listing standards, in contrast, require companies to form an audit committee made up entirely or primarily of independent directors.

In a position paper released this past March Keidanren suggested that corporate boards strengthen the role of inside auditors by appointing former chief executives of the company or by extending the terms of auditors to make them more independent.[7] Many Japanese business leaders consider the election of true outside directors and auditors to be too radical a move for the time being. Yet some analysts expect that, sooner or later, Japanese stockholders will push for the inclusion of independent directors and auditors to ensure that shareholders' interests are protected.

Shareholders - Whether individuals or big institutional investors, shareholders have even less say in how public companies in Japan are run. In fact, Japanese corporate executives' abilities often are assessed by how quickly they conduct the annual shareholders' meeting. The best managers supposedly end the meeting as soon as they can without any disturbance (typically in under 30 minutes). The Commercial Law prescribes the issues that must be approved by stockholders, including the selection of directors and auditors and their compensation, the company's financial statement and the allocation of aftertax corporate income. Since debate gives the public a bad impression of management's skills, corporate executives worry about opposing views. Organized protest groups known as *sokaiya* — which in many cases are affiliated with gangsters or *yakuza* — used to take advantage of shareholders' meetings to threaten managers (see *JEI Report* No. 18A, May 8, 1992). In an effort to prevent *sokaiya* activity most major companies hold their annual meetings on the same day. Under these circumstances it is unusual for shareholders, particularly individual owners, to express their views at the meetings.

Government - In the wake of public criticism last year against what was perceived as government negligence in handling disclosures of unethical or improper activities by Japanese brokerage houses and banks, Tokyo has shown more interest in protecting shareholders' rights and strengthening oversight of the securities and banking industries. Various analysts have pointed out the conflicting roles played by the government as promoter and protector of industry as well as its regulator. The Ministry of Finance, for example, traditionally has been responsible for supervising the securities market, but it also promotes the activities of brokers through regulations and administrative guidance. To address the conflict inherent in this dual role MOF recently established the Securities and Exchanges Surveillance Commission to police stock trading (see *JEI Report* No. 29B, July 31, 1992).

Outside Influence - American investors owning stock in Japanese companies also are calling for changes in corporate governance. They want to see improvements in such areas as disclosure of financial information and the way in which shareholders' meetings are run. Pushed by T. Boone Pickens, who failed to win a director's seat despite being the major shareholder in Koito Manufacturing Co., Ltd. (see *JEI Report* No. 38B, September 29, 1989), U.S. trade officials participating

in the 1989-90 Structural Impediments Initiative talks included on their list of necessary changes in Japan protection of minority stockholders' rights and more extensive disclosure of corporate financial information. In the second annual follow-up report on the SII talks, released in late July (see *JEI Report* No. 30B, August 7, 1992), Tokyo noted that the Legislative Council, which is looking into ways to enhance shareholders' rights, has been examining "such specific issues as improving shareholders' access to corporate financial books and records by relaxing share requirements ... and facilitating derivative lawsuits."[8] Tokyo also said that it expected Japanese companies to give "careful consideration to avoid[ing] possible obstacles to the exercise of shareholders' voting rights by foreign shareholders."[9] Japanese investors, too, support the idea of expanding shareholders' rights, especially with the steep drop in stock prices.

New Thinking on Stock Ownership

Although the United States and many other industrial countries give corporations broad permission to buy back shares in their company from stockholders and hold that stock, such flexibility is missing in Japan. In each of the following situations firms that acquire their own shares have to dispose of the stock almost immediately:

- Firms can acquire their own stock as a way of decreasing their capital.
- Firms temporarily are allowed to hold their own shares after mergers with companies in which they hold shares. For example, if company A merges with company B, which owns stock in company A, or vice versa, the resulting venture can hold its own stock briefly.
- Company C, which has claims on company D's assets, can get back its own stock held by company D if company D fails to repay the debt and has no valuable assets other than the stock.

Japanese businessmen cite several advantages to a company being able to hold its own shares indefinitely.[10] First of all, company ownership of its own stock limits the number of recipients of dividends, thus increasing the payout per share. Moreover, firms with surplus cash can use this money to buy their own shares rather than invest it in possibly unprofitable ventures; in the process they give a boost to the price of their stock. In addition, if Japanese companies were able to own their own shares, they could introduce stock options for executives plus employee stock benefits that are popular in the United States. Stock options, it is argued, would encourage corporate managers to limit their drive for market share at the expense of profits and to be more responsive to shareholders' interests since they would have a financial stake in the company's performance. Finally, self-ownership can provide an alternative to the mutual shareholding practice now employed by Japanese companies. This option often is used in the United States to defend against hostile takeover bids. If it were available in Japan, public corporations would have one less reason to ask other companies to hold a large proportion of their shares without the expectation of economic benefits through dividends or share-price appreciation.

In response to corporate Japan's urging the ruling Liberal Democratic Party this past June suggested that the Commercial Law be amended to give companies more leeway to hold their own shares. The party, however, cited a need to retain certain limitations on this practice. The Legislative Council now is studying the issue.

Conclusion

The Japanese style of corporate management often is characterized as being based on a long-term perspective. Since the majority of shareholders in many Japanese firms consist of friendly institutional investors, managers have a rather free hand. These investors make few demands even though the return on their investments in terms of dividends is relatively small. A stable base of stockholders that rarely rocks the boat gives corporate executives the freedom to invest in various ventures without the need for quick returns. While such a management style is sometimes claimed to contribute to the competitiveness of the Japanese economy, it looks somewhat protected or insulated in the view of U.S. executives, who have to answer to the more insistent demands of shareholders.

The current slump in the Japanese economy and the accompanying pressure on stock prices have prompted institutional investors and corporate executives in Japan to review their relationships with one another. Major stockholders are pushing for higher dividends and the disclosure of more information related to corporate management. This campaign, however low-key in American eyes, indicates that Japanese corporate executives no longer have the complete management flexibility they once enjoyed. Signs of change still are sporadic, but there are indications that Japanese corporate management is moving in the direction of the American version. This shift may weaken the competitiveness of Japanese companies in the short run. But through the process of change Japanese business practices will become more transparent and easier for domestic and foreign business partners to understand. In this sense change is inevitable if the economic systems of Japan and other countries are to be harmonized.

For further information, contact **Tadashi Saito**.

Notes

[1]"Haito Seiko No Kaizen Hitsuyo (Necessity of improving the rate of profit return)," *Nihon Keizai Shimbun*, June 29, 1992, p. 7.

[2]"Special Report on Corporate Governance," *Nikkei Business*, June 15, 1992, pp. 10-27.

[3]Keidanren, *Keidanren Kigyo Kodo Kensho (Keidanren Charter for Good Corporate Behavior)* (Tokyo: September 24, 1991).

[4]Interview with David Compton, associate director, NASDAQ Stock Market, and John Pilcher, attorney, Office of General Counsel, National Association of Securities Dealers, Washington, D.C., April 24, 1992.

[5]Dale M. Hanson, "What Does CalPERS Want?," *The Corporate Board*, September/October 1991, p. 3.

[6]Masahiko Aoki, "Toward an Economic Model of the Japanese Firms," *Journal of Economic Literature*, XXVIII, March 1990, pp. 1-27.

[7]Keidanren, *Kaisha Hosei No Arikata Nituiteno Keikai (Statement on Ideal Corporate Legislation)* (Tokyo: March 10, 1992).

[8]*Second Annual Report of SII Follow-up*, July 30, 1992.

[9]*Ibid.*

[10]Shoken Dantai Kyogikai, *Jiko Kabushiki Shutoku Nitsuite (A Study on Holding Own Company's Stock)* (Tokyo: July 7, 1992), pp. 43-47.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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